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TAGS: EFIN ECON ETRD EINV EC
SUBJECT: Ecuador's 2010 Budget: Optimistic Assumptions, large Deficits, Scarce Financing

REF: QUITO 1026

CLASSIFIED BY: Heather M. Hodges, Ambassador, U.S. Department of State, EXEC; REASON: 1.4(D)

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Summary

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¶1. (SBU) Marked by optimistic growth and revenue assumptions, a record-level fiscal deficit, and a conspicuous lack of detail about sources of financing, Ecuador's 2010 budget passed the National Assembly December 22. President Correa's administration submitted the 2009 and 2010 budgets simultaneously in November to the National Assembly, along with the constitutionally-required "Plan for Well-Being" Budget Plan covering 2009 to 2013. Private analysts have criticized the GoE's delay in submitting the 2009 budget and the unrealistic assumptions included in the 2010 budget. Critics predict the 2010 fiscal deficit will be up to a third larger than anticipated, and this does not even take into account the fiscal impact of the current electricity crisis. Many analysts consider the GoE's fiscal situation unsustainable, and given difficulty in obtaining external financing, the GoE faces either cutting social programs or committing to the risky strategy of using official reserves to finance the fiscal gap. End Summary.

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2009 Budget Proposal and the Plan for the Good Life

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¶2. (SBU) Ecuador's National Assembly approved the 2009 consolidated public sector budget proposal on December 22. President Correa's government had finally submitted the 2009 budget to the National Assembly on November 6, just weeks before the end of the fiscal year. According to the budget, Ecuador will end 2009 with a fiscal deficit of US$1.82 billion (3.6% of GDP) and a primary fiscal deficit (excluding payment of interest on debt) of US$1.22 billion (2.4% of GDP). Real annual GDP growth, as calculated by the Central Bank, is estimated at 0.98% for 2009. (This contrasts sharply with the clear consensus in the private sector that the Ecuadorian economy is facing a contraction for full year 2009.)

¶3. (SBU) Also on November 6, Ecuador's National Planning Secretary sent the National Assembly the "Plan Nacional Para el Buen Vivir, 2010-2013" (roughly translated as the "national plan for well-being"), which defines 12 national economic and social development objectives. These include the reduction of social inequality and improvement in the quality of life, peace, employment, political participation, and national sovereignty. This plan also aims to establish an economic system focused on the redistribution of factors of production and the promotion of local industries. Depending on international oil prices, the plan contains different investment scenarios for the four year period, ranging from US$18.9 to 22.3 billion. The National Assembly has not yet approved this plan.

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2010 Budget Forecasts 6.8% Growth

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¶4. (SBU) The National Assembly also approved the 2010 consolidated public sector budget proposal December 22, which the GoE had also submitted to the National Assembly on November 6. The National Assembly subsequently requested that the GoE allocate more resources for local governments and divert US$58 million earmarked

for debt payments to fund education and health programs. The final version incorporates these suggestions.

¶5. (SBU) The GOE proposed a US$21.28 billion budget for 2010, an 11% increase over the US$19.17 billion budget proposed for 2009. The 2010 budget is based on macroeconomic assumptions that many economic analysts consider significantly optimistic. The most criticized assumption is the expectation of 6.81% real annual GDP growth, as calculated by Ecuador's Central Bank. (Comment: local analysts, along with the World Bank, ECLAC, and Wall Street banks, all estimate 2010 real growth in the much lower 1- 3% range.) Optimistic revenue estimates, dependent on the almost 7% growth figure, are also seen as unrealistic. The budget estimates total revenues in 2010 of US$17.09 billion, up 9.7% from the US$15.57 billion estimate for 2009 (and down from US$20.8 billion in 2008).

¶6. (SBU) Analysts have also criticized the budget's estimate of an average price for Ecuadorian crude oil of US$65.9 per barrel during 2010, and for expecting the oil and natural gas extraction industry to grow 1.3% in 2010, when oil production has decreased every year since 2006. (The Central Bank estimates the non-oil economy will grow at a 7.7% annual pace.) Although the current price of Ecuadorian crude is close to $65/bbl, other countries such as Venezuela and Mexico have used estimates closer to $50, which analysts have noted is a more prudent strategy in the current highly-volatile global economy.

¶7. (SBU) The GoE has changed the way it calculates the 2010 budget compared to prior years, so it is difficult to compare statistics between the various budgets, particularly with regards to expenditures. However, the well-known Ecuadorian consulting company "Fiscal Policy Observatory" estimates that the 2010 budget includes a roughly 30% increase in expenditures over 2009. This compares to an approximately 18% decline in expenditures in 2009 and about a 70% increase in spending in 2008.

¶8. (SBU) Approximately US$5.8 billion or 27.43% of the 2010 budget is allocated to cover public sector salaries. Since taking office the Correa government has dramatically increased the size of the public sector in terms of both number of employees and higher wages. The public sector wage bill has increased 66% between 2007 and 2010 (projected). Public investment is projected at US$3.8 billion (17.91% of the budget) in 2010, and capital expenditures and repayment of public debt US$3.86 billion (18.15%), with debt payments totaling about US$1 billion. (The estimated total debt to GDP ratio in 2010 is 23.2%, while the estimated external debt to GDP ratio is 15.3%.) The budget also estimates 2010 inflation at 3.35%, basically equivalent to 2009, and projects a slightly positive trade balance compared to the US$1.33 billion trade deficit estimated for 2009.

¶9. (C) Comment: In private conversations with Econoffs, Central Bank officials have explained that they derived the budget's macroeconomic assumptions based on data and assumptions (e.g., for the price of oil) provided by the Finance Ministry and the National Planning and Development Secretariat (SENPLADES). While the almost 7% growth figure is achievable using these data and assumptions, Central Bank officials emphasize that there are "a lot of assumptions that are questionable."

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2010 Budget Deficit and Sources of Financing

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¶10. (SBU) Under the aforementioned macroeconomic assumptions, the 2010 budget proposal reflects a fiscal deficit of US$3.085 billion and a primary fiscal deficit of US$2.38 billion, equivalent to 5.4% and 4.3% of nominal GDP respectively. Finance Minister Viteri has announced that the budget deficit will be funded with new debt, as Ecuador expects to obtain external financing of about US$2.18 billion and internal financing of US$1.69 billion. The Ministry of Finance has mentioned the following external sources of financing: the Inter American Development Bank (US$ 971 million), the Andean Development Corporation (US$ 458 million), and "friendly" governments such as Russia, China and Iran. Domestically, financing would come from the State Social Security Institute (IESS).

¶11. (C) Local economic analysts have expressed serious doubts about the GoE's ability to find sufficient sources of internal or external financing to cover the fiscal gap. Central Bank officials informed Econoffs privately that the Finance Ministry refused to discuss details of sources of financing with the Central Bank, calling it "top secret."

¶12. (C) Expected multilateral financing is significant, but project-specific and only covers about a third of the anticipated fiscal gap. Funding from IESS is questionable, as it has already allocated much of its liquid resources for 2010. A senior Finance Ministry official told Econoffs December 10 that it has not proven as easy as expected to raise financing from non-traditional foreign sources. President Correa recognized as much during various speeches in December, calling Chinese requirements for lending to Ecuador -- particularly linked to US$ 1.7 billion in financing for a hydroelectric dam in Ecuador -- "humiliating for the country," and claiming that, "not even the IMF treated us this way."

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Private Analysts Consider 2010 Fiscal Plan Unsustainable

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¶13. (U) Local analysts consider it hypocritical that the GOE plans to finance the budget deficit for 2010 with new debt after GOE officials have spent the last few years severely criticizing debt contracted by previous governments. Ex-Finance Ministers and local economists Mauricio Pozo and Fausto Ortiz have both publicly questioned the ability of the GoE to obtain sufficient public financing to cover 2010 planned expenditures, and have also questioned the costs of raising financing from nontraditional sources such as China. While there is a clear role for private investment to help reenergize the economy, both Ortiz and Pozo point out that the GoE's policies of deemphasizing the role of the private sector and promoting State intervention in the economy have created strong disincentives to private investment.

¶14. (C) Jaime Carrera, head of the Fiscal Policy Observatory think-tank, has been one of the most consistent and vociferous critics of GoE fiscal policies and the assumptions included in recent budgets. In meetings with Econoffs, he described the 2010 budget as "populist" and "destructive" and argued that the projected spending increase in 2010 was "unsustainable." He disputed that GoE public investment will have much of a stimulative impact on domestic consumption and growth, arguing that much of "investment" will actually go to pay government salaries. He also argued that any expansionary impact of recent spending would be offset by the increased tax burden on businesses and increased controls on the financial sector. He estimated much lower economic growth in 2010 and also expected revenues to come in well below budget estimates. Therefore, he predicted the 2010 fiscal gap would likely exceed US$4 billion, or roughly a third larger than the GoE's already record-level (in nominal terms) estimate.

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## Power Shortages Impact on the Budget

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¶15. (SBU) Ecuador has faced severe power shortages since November 2009, with private estimates of economic losses on the order of US$ 1 billion. Although GoE officials dispute this figure, they admit to capital expenditures of US$ 245 million so far to increase power supplies, and are facing hundreds of millions more to add capacity and pay fuel and electricity subsidies. These investments and expenditures were not included in the 2009 and 2010 budgets and will thus contribute to an even larger than anticipated fiscal gap.

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## Comment

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¶16. (C) Most private analysts believe the 2010 budget has overestimated growth and revenues and is highly unrealistic in terms of maintaining a high rate of growth for public spending. As Ecuador is a dollarized economy, eliminating the GoE's ability to print money, analysts, therefore, have major concerns about fiscal stability, given the lack of financing, the difficulty in increasing tax rates, and declining oil sector production. These analysts predict the GoE will face a difficult task of maintaining the level of expenditure growth envisioned in the 2010 budget. The two obvious solutions to this situation are either to cut funding for politically important social programs or resort to the use of official reserves to fund the fiscal gap. So far, it appears the GoE, at the behest of President Correa, is pursuing the latter

strategy (septel). Current reserve levels of about US$4.5 to 5 billion are sufficient to allow the GoE to continue a high rate of expenditure growth through 2010 while avoiding a liquidity crisis. However, this is a high risk strategy that will leave Ecuador vulnerable to more severe fiscal and economic problems in 2011.
HODGES